

**TESTIMONY TO THE
HOUSE COMMITTEE ON AGRICULTURE**

**RESTRUCTURING IN THE COOPERATIVE SECTOR
AND NEW GENERATION COOPERATIVE STRUCTURES:
FINANCIAL AND CREDIT ISSUES**

**Roger G. Ginder
Economics Department
Iowa State University
Ames, Iowa**

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Chairman Goodlatte, Ranking Member Stenholm and distinguished members of the Committee, my name is Roger Ginder. I am a professor in the Economics Department at Iowa State University. I appreciate the opportunity to present testimony on the restructuring now occurring in the cooperative sector, business structures being used by new generation cooperatives and associations of producers and the financial health and credit needs for U.S. cooperatives. I will first address the topic of restructuring in the cooperative sector then the topic of business structures used by new generation cooperatives. Financial and credit issues will be incorporated into both discussions.

Part I: The Restructuring in the U.S. Cooperative System.

Cooperatives serving U.S. agriculture were created to serve the needs of the farmers and ranchers who own and control them. As a result it comes as no surprise that the changes that have occurred in the farm and ranch sector of the economy is being reflected in the coop sector. Decades of farm and ranch consolidation into fewer and larger units have created a radically different set of needs and expectations for the cooperative sector that serves them. This has created an absolute necessity for structural change at the cooperative level in order to meet the new and changing needs of the producers who own them.

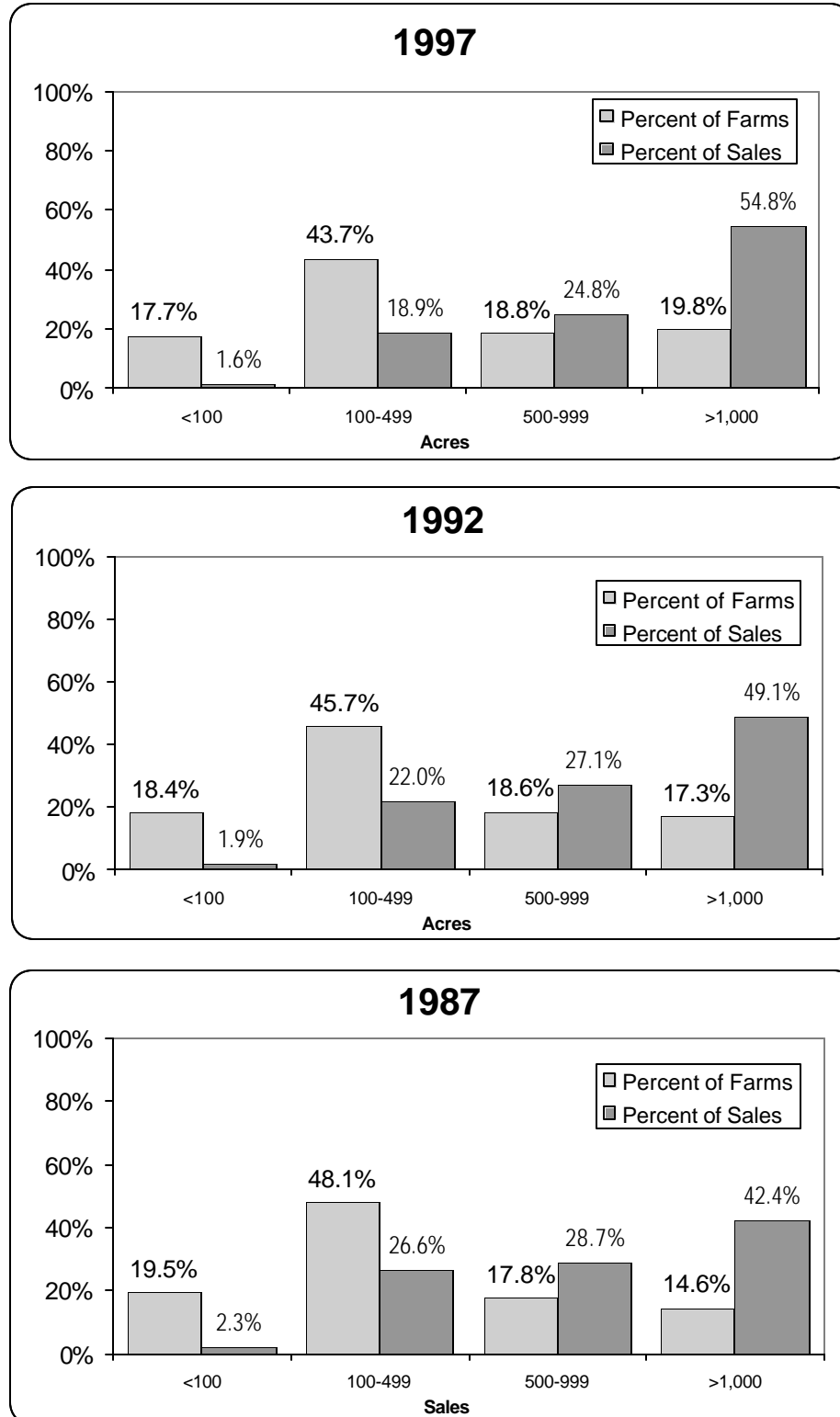
Most of the input supply and commodity marketing cooperatives operating today were formed in the period 1900-1940. At that time the number of farm operators was much larger and their operations were much smaller and more similar than is the case today. Farms and ranches tended to be full time operations that fully employed the family labor available. They were more diversified and much less reliant on purchased inputs and expensive technology than is the case today. The cooperatives they formed reflected the more or less homogenous needs of this kind of membership.

The number of farms has plummeted since then. In 1940 the number of farm operations in the U.S. was approximately 6.3 million. The most recent Census of Agriculture indicates that the number had fallen to approximately 1.9 million by 1997. But the decline in numbers tells only part of the story. Over the past 2 1/2 decades there has been an accompanying trend toward concentration of production into the hands of a smaller and smaller fraction of the remaining farms and ranches in existence. Thus the size disparity among the relatively small number of farms that continue to exist has increased remarkably. This phenomenon is illustrated in Figure 1 for grain production. A concentration of more than 55 percent of production is in the hands of less than 20 percent of the farms or about 116,500 farmers.

Much like the farmers and ranchers who created them, the number of U.S. cooperatives has declined and the size has increased significantly. Some would argue that the changes in the cooperative sector still lag behind the changes occurring among their membership. This is probably the case. To a large extent this has been possible because the gross

Figure 1

**Distribution of Farms Producing Grain
by Farm Size**



Source: Census of Agriculture, 1987, 1992 and 1997.

number of acres operated has remained more or less stable while the quantity of purchased inputs per acre has on balance increased. Although the number of producers is smaller, the more stable business volume has slightly moderated the need for cooperative consolidation thus far. But the continuing effects of declining farm numbers and the accelerating concentration of production into the hands of fewer and fewer farm operations will ultimately be the determining factor. The impact of concentration is rapidly overtaking any moderating effects arising from stable business volume.

It is clear that the relatively small group of farmers who now account for the majority of production will have different expectations for the cooperatives they own and use. It is also clear that this smaller group will not wish to own as many separate cooperatives as the previous and more numerous generation owned. There are fewer of them to capitalize the system and the demands for capital in their farming or ranching operations is significantly higher. They are not likely to be able to provide a sufficient equity capital base to finance the more numerous (and by today's standards sometimes duplicative) cooperative assets financed by the previous generation. These facts taken together mean that there is now (and will continue to be) a need for the cooperative system to restructure itself into fewer, larger, and in many cases refocused organizations in order to meet the needs of the current and future producers. It also means that consolidation and sometimes failure will occur among the existing local and regional cooperatives.

It is fair to ask the questions: Will these fewer and larger farm operations still need cooperatives? Are cooperatives still an important institution for grain farms of 3000-5000 or more acres? Are cooperatives still important to dairy farms with 2400, 4800 or more cows? I believe the answer is yes. By historical standards these farm businesses are quite large and when viewed in the context of a local rural area or local market they appear to be powerful and influential. However when viewed as part of the developing value chains for food and fiber, their individual economic power and influence is severely limited—possibly even more limited than it has been in the past when farms were much smaller and more numerous.

Farmer-owned cooperatives have long served as the farmer's link backward into the farm input chain and forward into the food and fiber value chain. The input value chains have recently undergone (and are continuing to undergo) rapid and at times radical change.

On the supply side of the producer, huge firms have developed in the seed and agricultural chemical industry. They are armed with valuable patents and can negotiate from strength. Dealing with firms of this size with a degree of parity will require cooperatives with larger membership bases, more effectively deployed capital, and more bargaining power. It will require cooperatives that can create real economic value in the chain and bargain effectively enough to obtain their fair share of the returns for what they create.

On the food side of the producer the change is perhaps more subtle, but it is every bit as significant. Since 1996 there has been rapid and significant concentration in the food-retailing sector. Mergers among existing regional and national food retailing firms and growth in the case of general merchandise retailers such as Wal-Mart have created a very

small cadre of national retailers that together account for a significant fraction of the total U.S. retail food volume. See Table 1. The five largest retailers currently account for nearly 40 percent of the retail food volume of the U.S. These retailers wield immense power and influence over the food side of the value chain and the firms in it. Regional food processors and manufacturers—both cooperatively owned and investor owned—will encounter pressures on brand margins and increasing difficulty in gaining access to the consumer.

Table 1. Market Share of Top Five U.S. Food Retailers

Retailer	Number of Stores	Estimated Annual Sales (\$ Billions)	Market Share (Percent)
Wal-Mart (Supercenters + Sam's Clubs)	1,765	126.7	17.4
Kroger/Fred Meyer	2,461	52.1	7.2
Albertson's	1,346	35.7	4.9
Safeway	1,793	35.0	4.8
Costco	522	31.7	4.4
Total Top Five	7,887	281.2	38.7

Source: Prepared from data published by Supermarket News, 1-13-03.

These firms are in a position to select suppliers who have the capabilities to provide fresh and processed food products to a nationwide network of retail stores rather than a statewide or regional network. To reduce costs and increase performance the number of suppliers they choose to deal with is likely to be very limited. In other words they are in a position to select which suppliers will have access to the 40 percent of the retail food market they currently serve. They are also in a position to develop and promote strong house brands that will compete with established regional and national brands. Farmer-owned cooperative processors and manufacturers will need to have the size and the logistical capability to serve national markets if they are to compete effectively in the new arena. In many cases restructuring from a system well adapted to regional brands and regional distribution systems will be critical.

These changes are already underway in some cooperatives. Mergers and consolidations in the dairy industry have created cooperatives that are nationwide in scope and capable of serving national markets. A farmer-owned cooperative holds the number four position in the soy processing industry. The cooperatives operating in many of the fruit and nut industries such as Sun-Maid, Blue Diamond, Diamond Walnut, and Valley Fig are either dominant or significant national scope players. Cenex-Harvest States (CHS) has become a significant player in the grain based food sector. In the beef industry U.S. Premium Beef has established a strong national position capable of creating value for retailers. In the turkey processing industry West Liberty Foods has, in a very short period of time, established a significant market position. Strong positions are also held by sugar beet refining cooperatives in the Upper Midwest and Plains states.

The high profile problems encountered by Farmland Industries in the Midwest, Plains and South Central regions and its subsequent bankruptcy have raised serious concerns about the position of cooperatives on the supply side of the farmer. It is an event that has engendered sense of sadness and loss among many of the farmers, local cooperatives, employees, rural communities, and others that had been associated with the cooperative over a long period of years. The failure of Farmland will result in the loss of significant cooperative presence and activity in pork processing and to lesser extent loss of capacity in grain marketing.

However, it should be recognized that much of the asset base and service capacity held by Farmland Industries prior to 2000 remains in the cooperative system today and continues to serve the producers who operate in those regions. A series of joint venture agreements were executed among Farmland Industries, Land O'Lakes and Cenex-Harvest States. Under these agreements four joint venture companies were formed—one for each of the major input categories (i.e., fertilizer and crop protection chemicals, animal feed, petroleum products, and seed). The intent was to create world class farmer-owned and controlled farm input business capable of serving the needs of the farmers of the future.

The four joint venture businesses formed were intended to provide size and focus in the market thereby more effectively using the existing assets of the three cooperatives. The assets of all three cooperatives under a single management in a specialized firm with the critical mass to deal with an increasingly concentrated and competitive market has greatly enhanced the position farmers enjoy in those industries.

Agrilience, the joint venture fertilizer and crop protection product distribution company formed is currently the largest firm in that industry. Cenex-Harvest States the major partner in the petroleum joint venture company currently holds a significant market share for petroleum products at the farm production level. Land O'Lakes the majority partner in the joint venture for animal feeds is currently the largest (noncaptive) feed manufacturer in the U.S. Land O'Lakes seed is the fourth largest distributor of crop seeds in the U.S. This kind of asset restructuring and refocusing is an important step in making the most effective use of limited equity capital available from a smaller and smaller number of agricultural producers.

As stated above, the value chains for the food and fiber produced on U.S. farms and ranches are becoming increasingly coordinated and will continue to be heavily influenced by very large and powerful firms. The changes in the value chain on both the input side of the producer and on the food and fiber output side of the chain will confront producers and their cooperatives with serious challenges going forward. Maintaining a strong bargaining position for those at the producer level in the value chain will be more important than ever before. If farmers are to be more than passive participants, it will be necessary for them to develop a position of parity or near parity with the other firms operating in the chain.

Finding the debt and equity capital to meet these challenges will continue to be a serious constraint in the cooperative system. Declining farm numbers coupled with the need for capitalizing cooperatives that are capable of creating value in a more concentrated competitive environment will not be simple. Nor will it be easily accomplished. Ultimately cooperatives have to become “investment grade” firms and consistently perform as such to accomplish it.

Cooperative restructuring and the redeployment of the capital already in the system more effectively is a necessary first step in dealing with these challenges. As stated earlier, there have already been efforts underway in the cooperative system to do this. Sources of competitively priced debt capital from a lender committed to providing credit to agricultural cooperatives will also be necessary. A critical factor in addressing the problem will be continued access to farm credit system lending from CoBank to provide the layer of senior debt required.

A third piece of the puzzle will involve more creative and careful use of the equity capital already in the system. Conversion of allocated equity to tradable shares with a return is being tested by some cooperatives as a means to conserve the scarce equity in the system and at the same time provide value to those who hold the shares. The cash demands on cooperatives to revolve equity from internally generated funds is a major drain that is not incurred by their corporate competitors. Finally other means of accessing outside capital including partnerships and joint ventures with firms either outside the value chain or at other levels in the value chain may in some cases be a practical alternative.

From a policy perspective several items can be helpful in the process. Legislation that enables the Farm Credit system and CoBank to provide needed credit to farmers and their cooperatives continues to be critical. The new marketplace may require new lending approaches and in some cases new authorities for lending to both farmers and their cooperatives. The more coordinated value chain places a higher premium on the rights of farmers to work together and bargain for their share of value created. It will be more critical than ever to preserve the existing provisions for collective action by farmers in the Capper-Volstead Act—including the right to form marketing agencies-in-common. Policies regarding membership and tax treatment of patronage distributions will also be important in some cases.

Part II. Issues in the Formation of “New Generation” Cooperatives or “Closed Membership” Cooperatives.

Open membership cooperatives have been proven to work well for such activities as input purchasing and undifferentiated commodity marketing. These tend to be activities where there are fewer binding constraints on increased volume handled through the cooperative. For example in grain merchandising once the fixed costs for a grain merchandiser has been incurred, the volume marketed can be increased with little marginal cost. Grain elevator handling capacity also involves large fixed costs. The capacity is often underutilized so that additional volume can be handled at very low

marginal cost. These conditions favor open membership policies because such policies make it easier to attract additional volume to the cooperative. The added volume tends to benefit all members including existing members by reducing unit costs or increasing bargaining power in the market.

However in activities where either: (1) binding facility capacity constraints exist on the amount of product that can be handled or processed or (2) market constraints exist on the volume that can be effectively handled, a closed membership cooperative is frequently used. For example, where the maximum plant capacity limits the volume that can be processed (at near minimum cost) limiting membership results in higher returns for existing members. Likewise where the market will accept only a limited amount of a differentiated product at margins above the commodity price, closed membership cooperatives are more attractive. Most of the value-added enterprises being formed have one or both of these characteristics. Additional volume in these cases tends to reduce the benefits to existing members rather than increasing such benefits. A membership policy that closes the opportunity to join when volume reaches the point of maximum efficiency serves to preserve the benefits to existing members.

The problem of reducing benefits for existing members is particularly important at the very early stages of cooperative formation and at the point where starting equity capital must be raised to finance the cooperative. Those involved in organizing the cooperative must expend a great deal of personal time and energy in the process of cooperative formation. The founding members typically receive little or no additional compensation or benefit from their efforts in organizing a new cooperative. Those who work to get the cooperative started will receive no benefit beyond the benefit received by members who subsequently join after the enterprise is already organized and operating.

Those who invest equity capital early in the life of the cooperative are in a similar situation. Since success is by no means assured it is safe to say that they are taking a significant risk in making this investment. Early investors must see and anticipate benefits from taking this added risk. They will prefer to add more members only up to the point where added volume will increase the efficiency of the cooperative and thereby improve returns for all existing members. There is little or no incentive for them to add more members (and volume) beyond that point since the added volume will only serve to reduce the benefits they already enjoy.

For these reasons many of the new cooperatives formed for adding value have been closed membership cooperatives rather than the more common open membership cooperatives involved in marketing undifferentiated commodities or purchasing production inputs. Fixing the membership at the level where the benefits will be highest for the membership and refusing to add volume beyond that point provides a necessary incentive for those to expend energy to organize the cooperative and those who make the initial investment in it. Permitting later volume to dilute these benefits would discourage the organization of these new cooperative ventures.

Closed membership cooperatives differ from the typical open membership cooperatives in several important respects that make them desirable for groups attempting to organize new ventures. Among the key differences are: (1) capitalization requirements in direct proportion to use, (2) shares that are tradable and not dependent on a board decision to redeem them, (3) specified delivery rights for raw product are typically granted, (4) equity share values that may rise (or fall) to reflect the value of the enterprise and (5) a relatively high fraction of the patronage payments to members are paid in cash and little or none of it is paid in the form of deferred patronage certificates. These characteristics of closed cooperatives provide several distinct advantages to farmers who are forming a new value-added venture.

Proportionality between the capitalization requirements for the member and the member's use of the cooperative insures parity between patronage refunds received and investment made in the coop. In other words distributions of net margins to individual producers based on their patronage are essentially the same as the amount they would receive if the distributions had instead been made based on the amount of equity they own. A sense of fairness is engendered.

Tradable shares permit members to partially or totally exit the cooperative by selling some or all of their shares. There is no need to wait for a board decision to redeem equities. It also provides the cooperative business itself a more permanent and stable equity position. There is no need for the cooperative to manage the cash flow demands associated with equity redemption. Once the shares have been sold and are in the hands of farmers it is up to the farmer to sell them to another producer when he or she wishes to exit.

Specified delivery rights and a specified delivery obligation provide the producer with an assurance that there is a market for the products produced. This assurance is quite important for commodities where few good alternative markets exist. Delivery obligations also provide added assurance that opportunistic behavior by individual members will be less likely to injure other cooperative members. There is assurance that the volume required for efficient operation will be available to the cooperative.

Share values that rise and fall with the success or lack of success of the cooperative provide producers with the incentive to manage the business more carefully and a return for taking prudent risks. The incentives and returns more closely resemble the incentives and returns that exist in non-cooperative businesses.

The requirement for capitalization up front and in proportion to the member's use of the cooperative permits most or all the distribution to be made in cash. This is in sharp contrast to the open cooperative which requires little or no up front capital but retains a significant fraction of the distributions it makes to its members as the primary means to capitalize the cooperative.

Added to these benefits are the more traditional benefits historically associated with both open and closed agricultural cooperatives. These include single tax treatment of patronage distributions, access to credit from CoBank, limited exemptions from securities laws and the Capper-Volstead anti-trust protections accorded farmer cooperatives. Indeed when most groups begin to organize, the cooperative form is what they have in mind. Despite the advantages cited above and their initial intent to use the cooperative form, most find that some of the restrictions associated with the cooperative form make it comparatively difficult and sometimes uneconomic to use.

Other forms including the Limited Liability Company (LLC's) can incorporate some but not all of the beneficial characteristics offered by the closed cooperative structure. LLC's usually adopt the delivery rights, tradability of shares, market valuation of shares, and other institutional practices of closed membership cooperatives. They cannot access the benefits of CoBank credit or some of the Capper-Volstead exemptions. LLC's can offer the same single tax treatment as closed membership cooperatives, but they are not saddled with some of the membership restrictions and outside investment restrictions historically placed on the cooperative form.

In addition, the LLC form of organization provides for even more favorable Self-Employment tax (SE tax) treatment than what has thus far been accorded to cooperatives. Those seeking to organize a value-added enterprise are almost invariably forced to weigh these advantages against the more traditional advantages of access to CoBank financing, limited exemption from securities registration, and the Capper-Volstead provisions that come with organizing as a cooperative. In the end it comes down to making a choice of one or the other and the immediate problems of raising capital from non-farm sources and more favorable SE tax treatment accorded to LLC's have often won out.

As a consequence, limited liability companies (LLC's) have become more prominent as a means for farmers to organize enterprises to conduct a value-added activity over the past several years. This has occurred primarily as a response to some of the limitations that the cooperative form of organization faces including the following: (1) Self-Employment taxation of distributions made to members, (2) limitations on who may be a shareholder, (3) ownership and voting limitations placed on non-farm investors and (4) limitations on the pass-through for the 10 cent small producer tax credit to cooperative shareholders (in the case of some renewable fuels activities). These factors taken together have led most start-up ethanol groups organized within the past five years to select the LLC form over the cooperative form despite the other advantages. A significant fraction of other types of value-added enterprises have also made this choice based on the first three factors. Unfortunately, this also means that these organizations are denied the benefits of CoBank financing; thereby eliminating a competitive source of debt capital from a knowledgeable lender committed to lending to producer-owned agricultural processing firms.

The classification of cooperative distributions as ordinary income and the distributions from LLC's as passive income can result in significant differences in value. The SE tax is levied at a rate of slightly more than 15 percent on cooperative patronage distributions

to their members. Distributions from LLC's in the vast majority of cases qualify as passive income and are not subject to this tax. All other things equal the value of the distribution to the producer is 15 percent higher when received from an LLC than it is when received from a cooperative.

In many cases the new value-added enterprise would not be making significant distributions to members during the start-up phase. However as soon as there are positive net margins and a distribution is made the differential tax treatment would immediately come into play. Requiring SE tax on the value of the raw commodity being processed (assume it is corn in this case) is not an issue. Since the Self-Employment tax would be levied on the producer's net income if he or she had delivered corn to an elevator and sold it at prevailing market price it could be argued that the value of the raw corn delivered to an ethanol plant should be subject to the same SE tax treatment.

However the added value (above the best local market price for corn) the farmer receives from investing in an ethanol plant, processing the corn and selling ethanol and by-products is also subject to the SE tax when the plant is organized as a cooperative. This is true despite the fact that the farmer typically plays no active role in managing or in providing labor for the plant. In contrast if we assume that the same set of producers, the same physical plant, the same management/employee group are operating as an LLC the added income would be classified as passive income and not subject to the SE tax. The cumulative effects of this disparity over time will be significant if the plant is successful. Despite considerable difficulties in converting a plant from a cooperative to an LLC, it may be the only rational choice when members are confronted with a recurring annual 15 percent disparity over the life of the firm.

Limiting membership to active farmers is also a source of difference between the cooperative form of organization and the LLC. LLC's may be formed with non-farm investors and farmers both holding full voting memberships. The majority of state cooperative statutes place strict limitations on permitting non-farmer members to vote. More recent state cooperative legislation (such as Ia. Chr. 501) currently permit some non-farm participation, but do not go far enough in the judgment of some who are attempting to include non-farm rural residents as participants in value-added ventures.

Several state statutes permitting more liberal membership requirements have either passed, been introduced into the legislature, or will soon be introduced. The first such bill was passed in Wyoming and signed into law in 2001. A very similar law passed in Minnesota in 2003. A similar bill has been introduced into the Wisconsin legislature for consideration later this year and Iowa has drafted similar legislation for introduction into its legislature when the 2004 session begins in January.

The intent in these cases is not to replace the statutes under which more traditional cooperatives are chartered. These statutes are to remain in place and those organized under them are under no obligation to convert. Rather the intent is to permit the formation of value-added cooperatives under a less restrictive statute that permits a cooperative to include more non-farm investors in its membership. Typically these

statutes would permit up to 85 percent non-farm ownership of the cooperative but would limit the voting rights of non-farm shareholders to 50 percent. They also permit membership and frequently charter across state lines. These structures remain largely untested, but are expected to put the cooperative form of organization on more even footing with the LLC form with respect to membership potential and voting rights.

Structures to achieve similar results similar to those embodied in the “Wyoming” law have been already established within the ethanol industry, but they are much more cumbersome and unwieldy. Where farmers wanted to use the cooperative form and needed to include substantial investment from non-farm sources, a two-tier structure was formed. Farmers formed a closed membership cooperative with delivery rights and capital to invest under the traditional cooperative statutes. Investors formed an LLC with capital to invest. A third entity was then formed as an LLC with the voting rights evenly split (see Figure 2). Albeit a more cumbersome process, the net effect was similar to

Voting 50-50

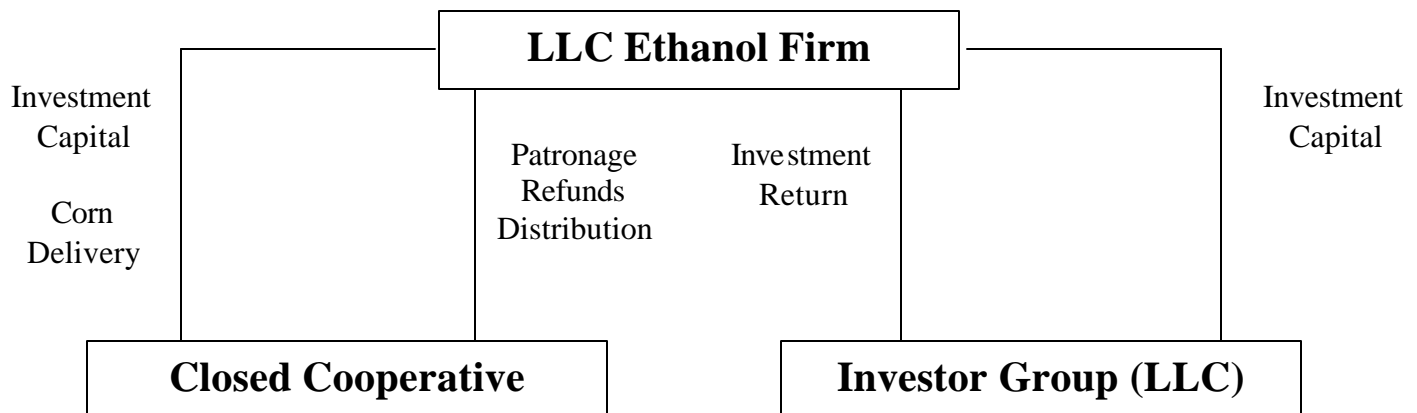


Figure 2. Alternative Organization Structures for Ethanol Production

what might be accomplished under the “Wyoming” type statutes. It should be emphasized that the problems of differential SE tax discussed above would still persist for any portion of the distribution that is issued on the basis of patronage.

Finally cooperatively organized ethanol plants have encountered difficulties in passing through small producer ethanol credits to producers. The inadvertent omission of cooperatives in the legislation has made it all but impossible for plants organized as cooperatives to pass through these credits. The recent conversion of the Tall Corn Ethanol Plant in Coon Rapids, Iowa from a closed membership cooperative to an LLC was associated with the problems of raising equity from non-farm sources. But another significant factor in the decision was the inability to distribute the small producer ethanol credit to members if it remained organized as a cooperative.

If this situation is not corrected soon, conversions by other plants now organized as cooperatives can be expected. Currently a plant producing 15 million gallons of ethanol per year is for all practical purposes unable to distribute the 10 cent per gallon credit to member producers if it organized as a cooperative. The net effect is to prevent the cooperative from making a potential distribution of \$1.5 million each year to its members. This constraint does not apply to similar enterprises that are organized as LLC's. Current proposed legislation to increase the small producer credits to include plants producing up to 60 million gallons will only serve to increase this already serious disparity.

From a policy perspective it would be desirable to make it possible for farmers to enjoy the same benefits from electing the closed cooperative form that they receive from the LLC form when they organize their farmer-owned value-added ventures. To the degree possible they should be able to select the cooperative form of organization without significant economic penalties.

Starting value-added ventures is an already difficult task for producers and it is useful to have as much flexibility in designing the organization as possible. Currently the enterprise must elect the LLC form if it is to avoid the SE tax on distributions to members. Likewise it must elect the LLC form of organization if it is to be allowed to pass through the small producer ethanol credit to producer members. But in doing so it must give up the ability to access CoBank credit services. It must give up the benefits and protections afforded in a well-developed body of cooperative law including the Capper-Volstead Act.

The inability to access CoBank credit deprives these start-up businesses of a stable low cost credit alternative with significant industry knowledge and a long-term commitment to providing financing to agricultural processing firms. Abandoning the protections of the Capper-Volstead Act could have future consequences if the value-added organizations in any of the industries where they are currently being organized wish to form marketing agencies-in-common.

Mr. Chairman and members of the committee, thank you for your interest in this important topic and for holding this hearing. I am grateful to have the opportunity to provide this testimony. I would be glad to respond to any questions you may have.